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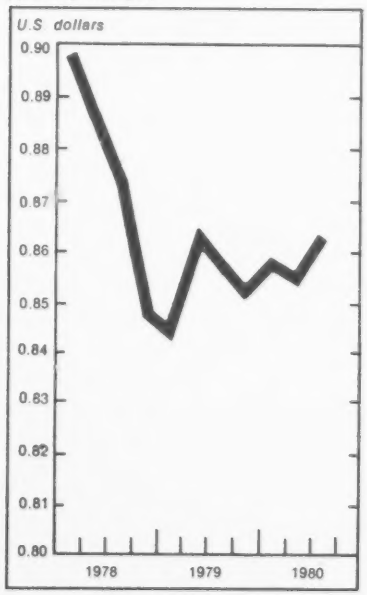
Canadian Dollar Outlook Clouded by Policy Shift

The world financial markets are paying increased attention to the state of debate over economic policy in Canada. There is a growing concern that the long-run implications of present policy drift may have a direct impact on the value of the Canadian dollar. The financial markets are used to political and economic turmoil. Indeed, from the perspective of the Canadian currency, the foreign-exchange markets have absorbed and discounted a series of Canadian political and economic shocks, especially since the 1976 Quebec elections. But they appear to have always focused—after initial adjustment—past the temporary problems and on the fundamental long-run strengths of the Canadian economy. The primary reason for this longer horizon is that market participants have expected that long-run Canadian economic policy would not diverge significantly from policy pursued in the United States. This anticipated convergence of U.S. and Canadian policy has kept the currencies of the two countries reasonably stable against one another, although the relationship has not always benefited the Canadian dollar.

U.S. dollar/Canadian dollar exchange rate
(quarterly averages)



There is a question, however, as to whether these long-run market perceptions may now be changing. As the United States appears poised to move in the direction of a freer economic environment, with deemphasis on the government's role and more stress on private enterprise to solve such problems as energy shortfalls and productivity declines, Canada seems to be moving in the opposite direction. Indeed, as 1981 unfolds Canada may find itself alone among the industrial nations—perceived as fiscally less conservative on various fronts, from fiscal stance to regulation. Much of this perception stems from the debate over energy policy. But there is increasing concern that government attempts to reconcile conflicting political interests will result in a tendency toward expanded public-sector deficits, higher inflation, and ultimately a more accommodating monetary and interest-rate policy.

The unique relationship that exists between the Canadian and U.S. currencies is widely acknowledged and has lent a good deal of predictability to Canadian exchange-rate movements. But it has existed because of the convergence of economic policy in the two countries. Thus, if the long-run economic policies of the two countries are seen as beginning to diverge, the question may be raised of whether the unique currency relationship will remain intact, or reemerge at a new and quite different equilibrium level.

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France's dependence on imported oil played havoc with its 1980 current account.

France's current-account deficit is provisionally estimated at 29.3 billion francs last year, an extreme reversal from the FF4.9-billion surplus of 1979. The deterioration was almost entirely the result of a trade gap that widened from 13.6 billion francs in 1979 to FF60.4 billion last year. And the chief element was the rise in oil prices, which swelled the total energy import bill by 48 billion francs. Oil is at the heart of France's current economic problems, as energy imports (mainly crude oil) satisfy almost 75% of domestic energy requirements. Continued dependence on imported oil makes the economy vulnerable to further price shocks in the short run. This year, the process of adjustment to the recent round of price hikes will again take its toll. The rate of inflation is unlikely to fall below 11%-13%, and a continuation of restrictive monetary policy will bring about a further loss of real economic output. Slowdown in import demand, however, should help offset costly oil imports and trim the trade deficit marginally. Longer-run prospects are more encouraging. France has formulated a highly ambitious energy policy whose objective is to cut reliance on oil from 56% of primary energy needs to 30% by 1990, chiefly by substituting nuclear power.

Danish economy contracting sharply in wake of deflationary policies.

The Danish economy is now showing the results of the deflationary policies adopted last year. Disposable incomes have been cut by 5%, the rate of inflation is running at an annual rate of less than 7%, and the current-account deficit has been kept to some 14 billion kroner. The government's ability to implement unpleasant policies seems to have won international approval, as evidenced by the terms of a $200-million Eurodollar borrowing announced in December 1980. The eight-year loan was granted at ⅝% over LIBOR for the first four years, with the spread rising to ½% thereafter—far better terms than given on previous financings. Nonetheless, economic output in Denmark is falling rapidly, investment has collapsed, and unemployment is edging up toward 8%. The government will thus come under intense pressure this year to relax its restrictive policy stance and stimulate economic growth, even at the expense of worsening inflation and balance-of-payments results.

Swedish kronor under pressure on fears of devaluation.

Gloomy forecasts of Sweden's economic performance presage a devaluation of the kronor some time in the future to improve export competitiveness and reduce the country's balance-of-payments deficit. Official forecasts published on January 12 anticipate a 22.8-billion kronor deficit on current account for 1981 and a swelling of the government's budget deficit to kr.64 billion. These forecasts triggered heavy speculation against the Swedish currency, forcing the authorities to boost interest rates and increase cash reserve requirements for commercial banks. The central bank discount rate was raised from 10% to 12%, with the penalty rate on commercial bank borrowings hiked from 13% to 17%. These responses underscore the government's desire to postpone devaluation until the conclusion of this year's national pay negotiations. The authorities may succeed in defending the kronor this time, but further bouts of speculation in anticipation of an eventual devaluation can be expected later this year.

Reduced oil output dampened Ecuador's economic growth last year.

Ecuador's economic growth rate slowed in 1980 as a consequence of reduced oil output. Real GDP growth is estimated at 4.3% last year, compared with some 5.3% in 1979. Uncertainty about the size of reserves and drilling delays cut average oil production to 200,000 barrels per day in 1980, about 6% below the previous year's average. Other sectors of the economy performed more favorably. Industrial production was up 9%, construction grew 4.2%, and agricultural output expanded by 2.5%. But the strength of the non-oil sectors, combined with rising wages, boosted the rate of price increase to 13% from 10% in 1979. The economic outlook for this year is for some improvement, based on the expectation of stepped-up oil production and continued growth in manufacturing. Inflationary pressures, however, will necessitate caution about excessive demand stimulation.

Paraguay recorded double-digit real GDP growth for the fourth consecutive year.

Paraguay's economy posted 10% real GDP growth last year, sustaining its record of double-digit output gains since 1977. All sectors of the economy contributed to the high growth rate. Agricultural output was buoyed by large increases in soybean, corn, and wheat production, with cotton and meat output showing smaller but still sizable gains. Timber output jumped sharply, and the construction industry recorded a steep rise in output as a result of giant hydroelectric projects under way. The higher level of aggregate demand, however, has kept prices rising at a 22% annual rate. The inflation rate would be even higher were it not for the restrictive monetary and fiscal policies being pursued. On the external front, the trade deficit in 1980 is estimated to have widened slightly. Still, the country's ability to attract international capital was not affected and reserves climbed by about $150 million.

IMF loan to Pakistan opens way for other needed sources of finance.

Late last year, Pakistan reached agreement with the International Monetary Fund on a $1.73-billion, three-year Extended Fund Facility loan, the largest loan ever granted by the IMF to a developing nation. To satisfy the conditions of the loan, Pakistan reportedly agreed to adopt measures to improve the profitability of public-sector enterprises and to slash subsidies further to bring its public-sector deficit under control. Ceilings on domestic credit expansion and on external borrowing by the public sector have also been imposed. Quantitative import restrictions are to be removed, and absolute bans on imports of capital goods, raw materials, and intermediate goods are to be relaxed. As a result of the agreement with the IMF, the Aid-to-Pakistan Consortium is reported to have approved about $270 million in debt relief for the next 18 months at its mid-January meeting. The IMF agreement may also pave the way for a structural adjustment loan from the World Bank.

Economic growth in Ivory Coast is slowing, but oil output prospects are bullish.

The Ivory Coast's coffee and cocoa boom, which gave it an annual average real GDP growth rate of 8% in the second half of the 1970s, has yielded to a period of economic austerity. Economic policy restrictiveness is a response to a substantially worsened balance of payments coinciding with a heavier external debt service burden. But sound economic management and a favorable petroleum production outlook point to a return to faster growth and an improving payments balance by 1982-83. Oil output is currently running about 10,000 barrels per day and satisfies almost one-third of domestic requirements. Production is expected to reach 140,000 bpd in two to three years, leaving an export surplus of some 100,000 bpd. The pace of real GDP growth is projected to drop to 1.5%-2% this year, but is expected to more than double in 1982 as a result of stepped-up petroleum development and a probable easing of public-sector investment restrictions. And the balance of payments, although burdened by increasing debt service payments, should begin improving in 1982 following this year's projected peak current-account deficit of $1.8 billion.

Cotton prices unlikely to rise significantly, despite tight supplies.

The cotton market is unlikely to see significant further price increases this year, despite reduced output and inventories. Estimated production of U.S. cotton for the 1980/81 crop year has fallen to 11.1 million bales from 14 million bales in 1979/80. The output decline occurred despite a 3% increase in harvested acreage, owing to a 26% drop in the average yield per acre—a result of last summer's severe drought. Worldwide production of cotton in the current crop year is down to some 64.1 million bales from more than 66 million bales in 1979/80. And world stocks are expected to decline to 20.4 million bales. Nonetheless, the expectation of weak demand this year and a widening in the price differential between cotton and certain cheaper substitutes should keep cotton prices from rising significantly. The most likely scenario for 1981 is for prices to remain in the 90¢ range, with cotton unable to sustain a price of more than $1 per pound.

NOWs Distort Money Numbers

The unexpectedly rapid growth in NOW accounts resulting from their recent introduction nationwide has created confusion about the significance of weekly money supply statistics. The key unknown is the extent to which the recent jump in the M1-B money supply was the result of this spurt in NOW accounts, and it will take some time before a reliable judgement can be made. In the interim, both the Federal Reserve and money-market participants will have difficulty determining whether money growth is "excessive."

At the start of this year, depository institutions nationwide received authorization to offer negotiable order of withdrawal (NOW) accounts. These accounts are equivalent to interest-bearing checking accounts, with a ceiling rate of 5¼%. NOW accounts are included, along with currency and checking accounts, in M1-B.

In the first two weeks of January, NOW accounts increased by $16 billion, and M1-B rose by $9.7 billion. Estimates of the rise in M1-B attributed solely to the introduction of NOWs vary widely, however, owing to varying assumptions of the sources of the NOW account increase.

If most of this increase represented transfers from checking accounts, the sharp rise in M1-B would have occurred even without the advent of nationwide NOWs. If much of the increase in NOW accounts reflected shifts from savings and time deposits, however, the introduction of NOWs would be a major cause of the M1-B jump. This distinction is important since the Federal Reserve is especially interested in the behavior of M1-B apart from the "nationwide NOW" impact.

Unfortunately, sufficient data are not available to make confident estimates of such effects. A reasonable, although *very* rough, estimate is that about 25%-30% of the rise in NOW accounts represents shifts from time and savings deposits. This estimate—similar to estimates of the effect of the introduction of NOW accounts in New England in the mid-1970s—implies that in the absence of nationwide NOWs, M1-B would have risen by about $5¼ billion in the first two weeks of January, instead of the reported $9.7 billion. This is still a large jump, but it implies that M1-B growth may still be below any Federal Reserve growth target.

Of course, the Fed's interpretation of the monetary data may differ from that given above. However, the Fed is well aware that any such interpretation is subject to significant uncertainty. Thus, it will probably place less weight on the behavior of M1-B in coming weeks in formulating policy, focusing more on the broader M2 aggregate. M2 includes small-denomination time and savings deposits and money market mutual fund shares, and is unaffected by the introduction of NOWs. The Fed is also likely to focus more heavily on money-market conditions and less on the monetary aggregates.

The Budget: Thorny Problems Persist

President Reagan will clearly have difficulty reconciling the provision of substantial tax cuts with his budget-balancing goals. The legacy of the Carter administration almost ensures it. In 1976, Jimmy Carter campaigned on a pledge to reduce both the inflation rate and unemployment rate to 4% and to balance the federal budget by the end of his first term in office. But inflation is now running over 12%, unemployment is near 7½%, and revised estimates for the 1981 fiscal year that began October 1, 1980 project a deficit of $55 billion. This shortfall compares with an estimate of $15 billion just one year ago, and is in sharp contrast to the projection of an $8-billion surplus three years ago. For FY1982, the budget submitted by Mr. Carter projects a deficit of $27.5 billion; a surplus is now not projected until 1984.

Even these estimates are likely to prove too optimistic. Any tax cut in the current fiscal year would enlarge the deficit unless offsetting reductions in spending are made. But the fiscal year will be at least half over before Congress could act on any legislative proposals, making offsets more difficult to achieve and a larger deficit more likely.

The herculean problem confronting the Reagan administration, however, is the budget for fiscal 1982. The estimated deficit of $27.5 billion specified in the Carter budget is only a hope. To hold the deficit to this figure, Congress would have to agree to $9.5 billion in spending cuts and to $23.6 billion in revenue increases—chiefly through a 10¢ per gallon excise tax on gasoline and withholding of tax on dividends and income. But Congress refused to approve these two revenue measures in the last session. Moreover, the Carter administration budget only allows for $18 billion in tax reductions, whereas President Reagan's tax cut proposals are likely to exceed $40 billion. Allowing for reflows to the U.S. Treasury of some $10 billion generated by a higher level of economic activity still leaves a gap of nearly $80 billion. Thus, many economists are urging large spending cuts, especially if defense expenditures are to rise.

The above budget estimates are also contingent on Council of Economic Adviser forecasts of real GNP growth of 1¾% in 1981 and 3½% in 1982, with inflation (measured by the GNP deflator) holding at about 10% in 1981 and falling to 9% in 1982. As the Council points out, however, two potential shocks to the economy could invalidate these forecasts. The first is the possibility of another major oil shock that boosts prices sharply. And the second is a possible collision between rapidly rising credit demands and the Federal Reserve's current monetary targets. This would tend to raise interest rates later this year and choke off economic recovery, sending receipts lower and expenditures higher. Given the budget outlook, however, the latter shock appears unlikely to be avoided.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate	exchange rate in U.S. dollars		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M_1)	January 28, 1981		current monetary conditions	
Austria	Economy slowing down in wake of German recession; inflation easing from midyear peak of 7.3%.	Apr.	+ 6.8%	67.9	+ 9.5%	Nov.	4,825	+ 33.0%	2.3	0	Slight narrowing of 1980's 42-billion schilling current-account gap seen.	Oct.	+ 6.8%	Oct.	+ 5.4%	6.75%	.0693	Credit continues restrictive.	Austria
Belgium	No real economic growth expected this year, after only 1% advance in 1980.	Oct.	— 3.4%	111.0	+ 2.1%	Nov.	8,028	+ 29.3%	1.3	0	Current-account gap expected to widen slightly to over $7 billion this year.	Dec.	+ 7.6%	June	— 1.6%	12.00%	.029965	Renewed franc weakness possible.	Belgium
Britain	Economic outout still declining, but a turning point is expected before midyear.	Nov.	—11.5%	403.1	+ 0.9%	Nov.	20,891	+ 7.8%	2.1	718	Payments surplus persists, owing to lower imports and growing oil exports.	Dec.	+ 15.5%	Oct.	+ 1.6%	14.00%	2.4100	Ma growth stays strong, but further rate decline expected.	Britain
Denmark	Output falling rapidly in wake of restrictive policy measures implemented last year.	Sept.	+ 9.5%	65.0	+ 3.5%	Nov.	3,274	+ 4.8%	2.1	0	Jan.-Nov. 1980 trade deficit was kr. 13.6 billion, vs. kr. 17.2 billion in 1979.	Sept.	+ 10.6%	Aug.	+ 4.5%	11.00%	.1562	Credit policy tight; competition among banks encouraged.	Denmark
Finland	Economy slowing down, but 1981 growth rate will still be among highest in Europe.	Sept.	+ 9.3%	40.5	+ 6.7%	Nov.	1,908	+ 32.6%	1.4	85	Current-account deficit widening sharply.	Oct.	+ 13.3%	Aug.	+ 4.1%	9.25%	.2541	Monetary policy remains restrictive.	Finland
France	Industrial production likely to show further drop in first quarter.	Nov.	— 4.5%	475.2	+ 3.2%	Nov.	28,580	+ 71.5%	2.6	0	Reduced import demand may narrow 1981 current-account deficit.	Dec.	+ 13.6%	Oct.	+ 8.3%	9.50%	.2086	Short-term rates ease with franc firm in EMS.	France
Germany	Real economic growth estimated at 1.8% in 1980; decline in real GDP likely this year.	Nov.	— 2.4%	766.8	+ 4.5%	Nov.	45,798	— 7.1%	2.9	0	Only small improvement foreseen for current account this year, owing to oil.	Dec.	+ 5.5%	Nov.	+ 6.0%	7.50%	.4812	Rates stay high, owing to weak DM and high U.S. rates.	Germany
Greece	Economy appears to have stagnated in 1980; reflationary budget should spur recovery in late 1981.	July	+ 2.0%	38.2	+ 3.8%	Sept.	872	— 9.6%	1.1	103	EEC-related capital inflows could help finance large trade gap.	Oct.	+ 24.3%	Apr.	+19.5%	20.50%	.0220	Credit highly restrictive.	Greece
Ireland	Deepening recession prompts government to announce plans to boost public investment.	Aug.	— 2.8%	14.7	+ 1.9%	Nov.	2,426	+ 16.0%	2.7	0	Current-account deficit running at an annual rate of 3-4 billion Irish pounds.	Aug.	+ 18.8%	Nov.	+16.3%	12.75%	1.800	Large budget deficit keeps rates high, despite recession.	Ireland
Italy	Economic downturn eases, but leading indicators continue to point downward.	Oct.	— 2.9%	324.2	+ 5.0%	Nov.	22,900	+ 25.1%	2.8	0	Jan.-Nov. trade deficit was $18.5 billion, versus $5.6-billion gap for all 1979.	Dec.	+ 21.1%	Sept.	+15.9%	16.50%	.001013	Credit remains tight.	Italy
Netherlands	Sharp recession began last spring; real GNP could contract in 1981.	Oct.	— 0.9%	148.8	+ 2.3%	Nov.	11,382	+ 51.6%	1.8	0	Gas export prices renegotiated in view of rising oil price.	Dec.	+ 6.7%	Sept.	+ 3.8%	8.00%	.4430	Credit easing in wake of guilder strength in EMS.	Netherlands
Norway	European recession pinching, but higher oil output ensures a healthy real GDP gain this year.	Oct.	+ 4.2%	44.5	+ 3.2%	Nov.	5,468	+ 25.2%	3.9	0	Payments surplus will narrow in 1981, owing to recent kroner appreciation.	Nov.	+ 13.1%	Sept.	+ 6.8%	9.00%	.1855	Accelerating inflation forces continued tight money policy.	Norway
Portugal	Political events have apparently not undermined business confidence.	May	+ 5.3%	19.3	+ 3.2%*	Oct.	1,092	— 3.1%	1.5	114	Current-account deficit forecast to expand slightly to $1 billion in 1981.	Sept.	+ 12.7%	July	+26.1%	18.00%	.0182	Money supply still growing rapidly.	Portugal
Spain	The only stimulus in 1981 expected to be public investment; 1% real GDP growth is forecast.	June '79	— 3.1%	196.0	+ 1.5%	Oct.	12,312	— 6.5%	4.5	252	Oil price hike likely to lead to 1981 current-account gap of about $5 billion.	Sept.	+ 14.6%	Sept.	+11.9%	8.00%	.0123	Money supply under control; credit generally available.	Spain
Sweden	Economic activity continues to slow down.	Sept.	0	100.6	+ 3.8%	Nov.	3,480	— 0.3%	1.2	0	Trade gap in 1980 was kr. 10.7 billion, versus kr. 4.8 billion in 1979.	Nov.	+ 14.6%	Dec. '79	+16.3%	12.00%	.2199	Credit tightens substantially in defense of kronor.	Sweden
Switzerland	Inventory liquidation likely as new orders fall.	Sept.	+ 4.0%	99.0	+ 0.7%	Nov.	12,735	— 8.8%	4.2	—	Trade deficit a record SF 11.2 billion in 1980.	Dec.	+ 4.4%	Oct.	— 7.3%	3.00%	.5330	Credit tight to maintain franc stability against DM.	Switzerland
Canada	Increasing demand pressures boosting consumer prices; unemployment rate falls slightly.	Nov.	— 1.7%	222.3	+ 2.7%	Nov.	2,528	— 14.5%	0.5	0	Record trade surplus the result of higher export prices.	Dec.	+ 11.2%	Dec.	+ 8.5%	17.00%	.8345	Bank loans up at 16% annual rate.	Canada
United States	Spillover from buoyant growth in late 1980 precludes immediate economic decline.	Dec.	— 1.2%	2,413.9	+ 3.2%	Nov.	14,511	+ 77.6%	0.7	0	This year shaping up as a banner year for U.S. trade.	Dec.	+ 12.4%	Dec.	+ 4.1%	13.00%	—	High interest rates keep dollar strong.	United States

*1978

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World Interest Rates

market rates as of Jan. 28, 1981; bond yields as of Jan. 23, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.00	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	17.00 Jan. 29	18.00	15.00*	8.60	10.75	9.10	17.50	8.875	2.50	9.0625
Treasury Bills 91-day, Middle Rates	15.05	16.85	12.875*	12.25	n. a.	n. a.	15.60	no dealing	no market	5.875 2-month
Commercial Paper prime, 3-month, asked	16.75 finance paper	17.00 finance paper 15% tax w/h	12.72*	11.50 Certified	11.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.30	17.15 15% tax w/h	13.125*	11.80 Certified	not traded	9.90	20.25	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.21	13.00	13.64	10.66 20% tax w/h	13.82	9.09	16.23	10.58	4.80	8.671
Industrial Bonds prime, long-term, new and old issues, average yield	13.10 Aa Industrials	13.875	14.22	14.675	14.71	9.19	16.55	11.58	5.832	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	18.25	15.00*	15.75	13.85	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00	6.00	7.50
Bank Time Deposits 3-month	16.75 Cert. of Dep.	16.25	14.00*	12.05	11.50	9.25	10.75	9.50 large deposits	6.00 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	18.1875	no market	14.25	no market	11.00	9.4375	no market	9.50	6.25	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8345	2.4100	.029965	.2086	.4812	.001013	.4430	.5330	.004883
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.875 *P*	4.50 *P*	6.00 *P*	6.50 *P*	9.375 *P*	1.25 *D*	8.25 *P*	11.50 *P*	8.75 *P*

Eurodollar Deposits
(London, interbank, bid)
Jan. 29

7-day	17.75
1-month	17.875
3-month	17.8125
6-month	16.875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n.a.
U.S.-Canada Treasury Bills	−1.80
U.S.-Canada Finance Co. Paper	− .885
Eurodollars-U.K. Local Auth. Deposits	n.a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.50
Over 7 yrs.	14.00
DM Bonds	
7 yrs. and under	9.25
Over 7 yrs.	9.375

Gold Price
London afternoon fixing
523.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of Jan. 21.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.4 (Dec.)	11.2 (Dec.)	15.5 (Dec.)	13.6 (Dec.)	5.5 (Dec.)	21.1 (Dec.)	4.4 (Dec.)	6.6 (Dec.)
Industrial production*	−1.2 (Dec.)	−1.7 (Nov.)	−11.5 (Nov.)	−4.5 (Nov.)	−2.4 (Nov.)	−2.9 (Oct.)	4.0 (Sept.)	1.9 (Nov.)
Trade balance† *(billions of local currency units)*	−$2.98 (Dec.)	C$1.56 (Nov.)	£0.25 (Dec.)	−FF3.57 (Dec.)	DM0.38 (Nov.)	−Lit.1,490 (Nov.)	−SF0.88 (Dec.)	¥500 (Dec.)
Money supply (M_1)*	4.1 (Dec.)	8.5 (Dec.)	1.6 (Oct.)	8.3 (Oct.)	6.0 (Nov.)	15.9 (Sept.)	−7.3 (Oct.)	−1.6 (Nov.)
Velocity of money (M_1)*	4.6 (Dec.)	10.7 (June)	8.6 (June)	n. a.	5.8 (June)	6.2 (Sept.)	n. a.	5.7 (June)
Reserves minus gold *($ million, change from previous month)*	1,710 (Nov.)	−199 (Nov.)	−597 (Nov.)	36 (Nov.)	−827 (Nov.)	791 (Nov.)	893 (Nov.)	253 (Nov.)

* Percent change from 12 months earlier.
† Figures are only for the month indicated.

Adjusting to a Multi-Reserve System

Despite the U.S. dollar's tarnished preeminence in the international monetary system, it remains the world's major reserve currency, accounting for some 80% of the world's foreign-exchange reserves. Reserve diversification has apparently begun, however, with the dollar gradually ceding some of its reserve and portfolio functions to such currencies as the German mark, the Japanese yen, and the Swiss franc. The process was precipitated by instability in the dollar's exchange rate and has been sustained by the expectation of continued dollar volatility.

The forces that have led to the phenomenon of dollar volatility are several. They include declines in U.S. economic growth and productivity coinciding with ballooning fiscal deficits, monetary expansion, and accelerating inflation, in addition to balance-of-payments deterioration and the build-up of dollars abroad. The U.S. government's freezing of Iranian assets last year heightened concerns further, hastening diversification by certain Mideast OPEC members. Having been launched, the process of reserve-currency diversification is expected to continue, reinforced by such factors as changing patterns of international trade and debt and non-dollar currency pegging practices.

Diversification away from the dollar has occurred in the wake of the abandonment of a dollar-centered system of fixed exchange rates in 1973. Had a system of freely fluctuating exchange rates emerged, the need for a reserve currency would have been largely precluded. What has emerged, however, is a system of *managed* floating exchange rates. National authorities have been unwilling to allow their currencies to float freely for fear of being exposed to excessive—and not necessarily corrective—exchange-rate fluctuations. They have instead opted to intervene in the foreign-exchange markets by either buying or selling reserve currencies to support predetermined exchange rate targets for their currencies. This has sustained the need for a reserve-based monetary system, in which several currencies are assuming the role that the dollar once played—under an exchange rate regime that is neither fixed nor floating.

The world's central bankers have moved slowly to diversify their reserve assets--recognizing the dollar's dominant reserve and intervention function and owing to their huge dollar holdings. (The reserve-currency countries actually increased slightly the proportion of dollars in their total reserves between 1970 and 1978, from 91.3% to 93.3%.) Private entities less concerned about the impact of their actions on the dollar exchange rate, however, appear to have moved more aggressively. And the Eurocurrency market has served as the main vehicle for purchasing such non-dollar reserves free from national restriction.

The monetary authorities of the emerging reserve centers remain wary of intervention roles for their currencies, largely because of the perceived constraints on domestic monetary control associated with sudden changes in the volume of externally-held short-term claims. But they have accepted the inevitability of reserve responsibility and are slowly opening up their financial markets to facilitate the requisite capital flows. Large current-account deficits in Germany and Japan have given the monetary authorities in these countries a strong incentive to encourage capital inflows, as has the desire to exercise control over the acquisition of their currencies that has proceeded unchecked in the Euromarkets.

The fundamental international monetary restructuring occasioned by a move from a dollar-based to a multi-currency reserve system has important consequences for international monetary stability. The stresses created by the process—and the measures needed to respond to them—occupied a primary role at a November conference on international monetary stability sponsored by the Philadelphia-based Global Interdependence Center in collaboration with the "Group of Thirty".

The key concern cited at the conference was the potential for heightened exchange-market instability created by the shift to a multi-currency reserve system. The increase in exchange-rate fluctuations, according to the conferees, would stem from the desires of central bankers to alter their currency portfolio mixes at the margin in times of dollar volatility, which could precipitate even larger private portfolio shifts. In general, however, the industrialized-nation central bankers limit their diversification actions to periods of relative dollar stability. They continue to "lean against the wind" by moderating exchange-rate movements and smoothing out speculative excesses through intervention in periods of dollar volatility. But central bankers in many developing nations are beginning to emulate the exchange-rate-management strategies of private currency holders, that is, minimizing risk and maximizing yield.

Various short-term mechanisms have been utilized to accommodate the stresses created by the shift to a multi-currency reserve system. The Japanese and German central banks, for example, have issued non-marketable yen- and DM-denominated government bonds (with maturities of one to five years) to the Saudi Arabian Monetary Agency to minimize potential exchange-market disruption.

For the longer term, however, there are only a limited number of options—or proposals—for restoring

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stability to the international foreign-exchange markets. These include: (1) a resurgence of the dollar's role as the world's unchallenged reserve; (2) the adoption of a "Substitution Account" within the International Monetary Fund; (3) a renewed reserve role for gold; or (4) accommodation to the current system of multi-currency reserves.

The dollar could regain its role as the world's unchallenged reserve vehicle if the U.S. monetary authorities succeed in restoring confidence in the dollar with policies that foster stable and non-inflationary monetary growth. If the dollar's exchange value is strengthened—with expectations of dollar stability reinforced—it could recover its past preeminence. Such a development, however, appears improbable, in light of the long history of use by U.S. economic policymakers of a "stop-go" approach, with spurts of monetary and fiscal restraint alternating with expansionism.

Perhaps the most publicized proposal advanced by international monetary reformers to deal more permanently with the problem, however, is the establishment of a Substitution Account within the IMF. Participating central banks would deposit foreign exchange —initially dollars—in an account administered by the IMF, receiving claims denominated in Special Drawing Rights (SDRs). The dollars deposited would be invested in some form of U.S. government obligation and the Account would pay a market-related rate of interest on the SDR claims.

The Substitution Account, however, failed to win approval by an IMF Interim Committee last April for two reasons: the SDR's illiquidity in world financial markets and the disagreement over who would guarantee the Account sufficient funds to pay the interest due on SDR claims in the event that the dollar depreciated relative to the SDR. And despite the SDR's recent redefinition—in which its currency basket was reduced from 16 to 5 currencies, all with forward exchange markets—it is unlikely to assume a key reserve function. The private market resists the concept of a rigid currency basket, which cannot meet the varied requirements of private entities. And if the SDR is not held and traded privately on a large scale, central banks cannot use it as an intervention medium. Moreover, a major reserve role for the SDR would require that the IMF be transformed into a supranational monetary regulator, which is unlikely, particularly in view of prevailing pressures to erode whatever regulatory powers the IMF has now. But although the SDR will probably not assume an important reserve function, its role as a convenient unit of account for both official and private transactions should continue to grow.

As for gold, there is little chance that it will assume a significantly greater reserve role in the future. Having become a speculative commodity, its volatility argues against remonetization. Furthermore, a larger reserve role for gold would necessitate an undesirable dependence on the world's two largest producers: the USSR and South Africa. And modern governments are unwilling to accept the constraints on domestic monetary policy required by a full gold standard.

In sum, the scenario most likely to evolve will be one of continued development of a multiple-currency-reserve system, in which diversification away from the dollar proceeds in fits and starts and where alternative currencies assume varying degrees of reserve functioning at various times. The dollar can be expected, however, to retain its dominant reserve role for some time in view of the currently large dollar capital market, the reluctance on the part of alternative reserve centers to assume important roles, and the incentive offered by U.S. political stability.

The question arises of how the stresses and imbalances associated with an evolving multiple-reserve system can be neutralized. An interim response considered at the Philadelphia gathering was for central bankers to agree on specific guidelines as to the structure of their reserve portfolios, thereby fostering increased exchange-rate predictability. They might also consent to acquire no further holdings in Eurocurrencies in return for some access to the money and capital markets of the new reserve centers. Although the incentives for diversification by the private sector would continue to be economic fundamentals, such intercentral bank cooperation might also moderate pressures for shifts in currency preferences by private currency holders.

The ultimate ingredient for stability in a multi-reserve system, however, is coordination by the major reserve-currency countries of their monetary policies to minimize the underlying incentives for speculative currency shifts. Such a goal is understandably difficult, however, because various national monetary authorities resist subordinating their national interests to those of international monetary cooperation. Nonetheless, should the stability of the world's monetary system continue to deteriorate, such cooperation may be forced onto the world's major central bankers, at a painful cost. Recently, there have been encouraging signs of international economic cooperation, as evidenced by the prevalence of restrictive monetary policies throughout much of the industrialized world. The hope is that such synchronization will be sustained and formalized into deliberate cooperation. The creation of the European Monetary System serves as an interesting—if yet untested—study of explicit monetary cooperation that may be adapted on a global scale.

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